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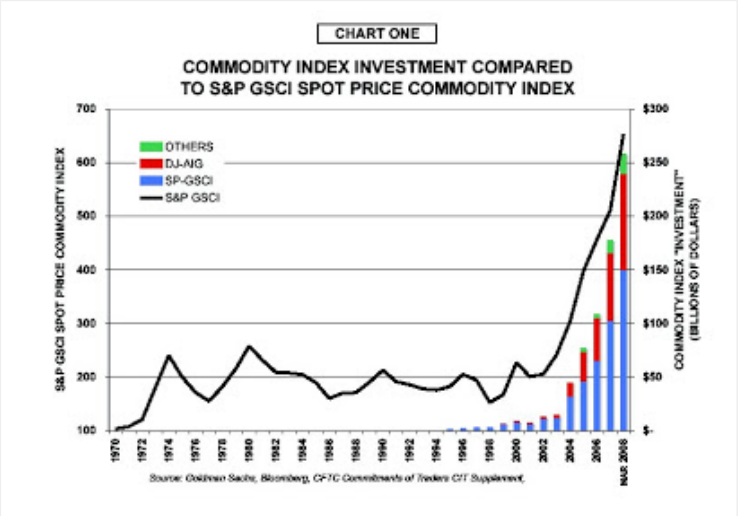
An unending variety of topics

Wednesday, June 04, 2008

The war against retirees



I am quite chagrined that a number of influential folks have almost reached the same conclusion as I, namely they've concluded that "speculation" not fundamentals are driving most of the recent commodities rise, yet they reach a policy conclusion that is utterly insane: restrict or ban much of this "speculation". They stop at the word "speculation", repelled in horror by the idea, and don't take it a step farther -- ask why this "speculation" is going on. A good clue comes from those responsible for the biggest piece of it -- retirement funds. Retirement funds have long been heavy, relative to other kinds of funds, on less volatile (over <15 year periods) investments like bonds. But bonds are mostly denominated in dollars. With the threat of dollar inflation (apparent from the recent drop in the dollar, from recent Fed activity, and from the history of the floating dollar in the 1970s) they have a fiduciary responsibility to protect their investors' retirement nest eggs by hedging bond positions with commodities baskets. And that is just what they have been doing. Besides providing an inflation hedge and a performance comparable to bonds since the dawn of the floating dollar era in 1970, commodities are also "anti-correlative", i.e. they tend to move in the opposite direction of stocks and bonds, substantially reducing the risk of the overall portfolio. To suggest that commodities are not proper vehicles for investment in this era of the floating dollar is stunningly pathological, but that hasn't stopped a number of people who should know better from suggesting this.

(I suspect a similar explanation is behind much of the high Chinese demand -- but that rather than buying futures they are actually stockpiling commodities, including cutting back on production of the mineral reserves that they own, to hedge their peg to the U.S. dollar, their massive dollar earnings from exports, and their heavy investments in U.S. Treasuries, all of which are vulnerable to dollar drop or inflation -- but I don't know where data on such stockpiling activity might be readily available).

Many of these retirement funds can be politically influential. I wish, for the sake of the retirees they have a duty to protect, they would defend themselves politically against the insane proposals to restrict or ban commodity index funds. Those seeking to save for

Pages

- Home

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Nick Szabo

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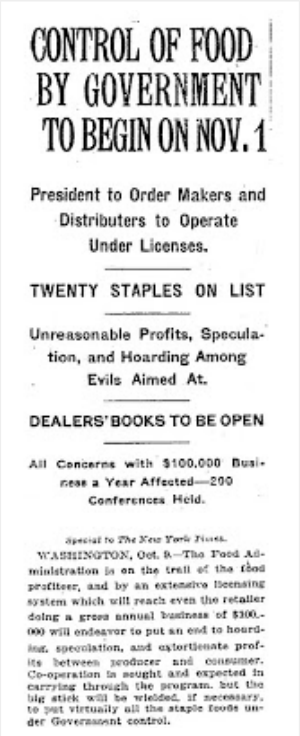
retirement have perfectly good and strong reasons for investing in commodity indices: they don't want to see their retirement funds eroded away by inflation, as happened to millions of seniors in the 1970s. More generally, people have a right to be free from ignorant government interference and federal spite when they choose to hold their savings in forms protected from the erosion of the dollar.

Commodity index exchange traded funds (ETFs) have allowed people to construct, without many of the costs, risks, and complexities of direct purchases of commodity futures, retirement portfolios hedged against inflation. Portfolios protected against inflation are an exceedingly valuable asset both for the retirees and for the society on which said retirees will be less dependent. They are also quite valuable for many other kinds of investors, such as college endowments that lower the cost of tuition for future students and fund research that benefits the future of us all. Instead of attacking the fever by shutting down the immune system, i.e. instead of attacking the commodities indices needed to hedge against inflation, it is the prior main cause of the problem, Federal Reserve monetary policy, that needs to be addressed. The Fed needs to put a higher priority on preserving the value of the dollar and fighting inflation, and it needs to use leading indicators (e.g. commodity and foreign exchange prices) far more than trailing indicators (e.g. CPI, PPI) in this task. (I understand of course that the recent credit crunch has probably been a very good reason for the Fed to "print dollars." That doesn't change the fact that the Fed is smack dab in the middle of the causal chain that has led to the commodities boom, and that savers have a right, and investment funds a fiduciary duty, to protect their savings against the inflationary effects of Fed policy).

It's certainly possible that some of the commodities boom is a bubble. It is often the case that economically efficient bull markets become overextended into wasteful bubbles, it being very hard to tell just how large of a price increase is actually warranted, and we may be seeing some of that now. (These bubbles are allowed to occur by a *lack* of available instruments for speculation, especially the transaction costs involved in holding long-term short positions against markets that may rise substantially further before they fall. The worst way to combat a bubble is to ban the last modicum of imperfect speculative mechanisms such as short sales that currently prevent bubbles from getting worse). There is no easy way to gauge just how much retirement funds and others seeking to hedge inflation need to allocate to commodities baskets in order to optimize their portfolios, because it depends greatly on future Fed behavior. On the one hand we know that hyperinflation has sometimes occurred historically with floating currencies, so that dramatic further increases in commodity prices are possible; on the other hand the farther commodity prices go up (and they have gone up very far indeed) without corresponding inflation in other goods and services, the more downside price risk there is in commodities. Oil next year might be $40 per barrel, or $300 per barrel, or anything in between. It's certainly true that commodities have become a far riskier, i.e. more volatile, investment than they were three years ago, and that puts a severe limit on the proportion of an investment portfolio it makes sense to devote to commodities. But that proportion is certainly nowhere near zero as the lunatic anti-"speculation" activists would have it.



CONTROL OF FOOD BY GOVERNMENT TO BEGIN ON NOV. 1

President to Order Makers and Distributers to Operate Under Licenses.

TWENTY STAPLES ON LIST

Unreasonable Profits, Speculation, and Hoarding Among Evils Aimed At.

DEALERS' BOOKS TO BE OPEN

All Concerns with $100,000 Business a Year Affected—200 Conferences Held.

Special to The New York Times.

WASHINGTON, Oct. 8—The Food Administration is on the trail of the food profiteer, and by an extensive licensing system which will reach even the retailer doing a gross annual business of $300,000 will endeavor to put an end to hoarding, speculation, and extortionate profits between producer and consumer. Co-operation is sought and expected in carrying through the program, but the big stick will be wielded, if necessary, to put virtually all the staple foods under Government control.

(This post is based on a comment I made on a previous post. Here,, h/t to reader "munin", is a hedge fund guy who reaches almost the right theory, but the abominable policy conclusion, and is the source of the graph above. Here is some of my previous writing on this subject: The Monetary Value of Liquid Commodities and Commodity Derivatives: The New Currencies).

[Update: at least we don't have war hysteria (or click to enlarge the facsimile at left). Note that Herber Hoover, who many history books still proclaim with preposterous prevarication to have been a free market guy, and who later presided over the start of the Great Depression, was at this time (1917) the head of President Wilson's Food Administration, which came up with this plan for "Control of Food By Government". Hoover's food plan, like the crazy plans to "fix" the commodities markets today, was designed by and for the ignorant and the paranoid, targetting "Evils" of "Unreasonable Profits, Speculation, and Hoarding", i.e. the "evils" of people stocking up to ensure own and their customers' future food supply instead of letting the benevolent Herbert Hoover control it for them. Today it is apparently evil to protect your

Blog Archive

- ► 2018 (1)
- ► 2017 (3)
- ► 2016 (4)
- ► 2015 (3)
- ► 2014 (3)
- ► 2013 (3)
- ► 2012 (8)
- ► 2011 (12)
- ► 2010 (9)
- ► 2009 (29)
- ▼ 2008 (55)
  - ► December (2)
  - ► October (2)
  - ► September (4)
  - ► August (9)
  - ► July (4)
  - ▼ June (6)
    - Commodity hysteria -- an overview
    - State vs. anarchy -- the false dichotomy
    - Green beards and master genes
    - Commodities, currencies, and the St. Petersburg pa...
    - U.S. Supreme Court breathes new life into first sa...
    - The war against retirees
  - ► May (6)
  - ► April (4)
  - ► March (10)
  - ► February (5)
  - ► January (3)
- ► 2007 (47)
- ► 2006 (130)
- ► 2005 (44)

retirement nest egg instead of letting it fall with the dollar].

Posted by Nick Szabo at 1:19 PM

7 comments:

Assaf said...

A very interesting read!

10:06 PM

Clayton said...

Looking at that 1917 NYT article makes me feel like I don't have much to bitch about in terms of today's interventionism. It's amazing to me the levels of government interventionism that our economy has survived.

Did anyone else notice the evocations of corporal discipline in the article, "the big stick will be wielded, if necessary", "... will feel swiftly the firm hand..." The opening sentence also evokes the image of a sheriff's canine posse on the trail of an escaped convict. Absolutely astounding.

Very eye-opening article.

10:23 AM

Kevin LeBleu said...

Ok, I have read your posts and understand how commodities can be used as a currency. What I don't understand is how you claim reducing "speculation" is a war against retirees, without addressing the impact on actual suppliers and consumers of these commodities.

Why should I pay higher prices for corn products just so retirees can have more certain retirement funds? I want the price of corn set so that the appropriate amount of corn is produced and consumed!

So can you please explain to me how using commodities futures as an inflation hedge (or new currency) does not cause a negative impact (market distortion) on the actual market for the commodity?

9:04 AM

nick said...

Why should I pay higher prices for corn products just so retirees can have more certain retirement funds? I want the price of corn set so that the appropriate amount of corn is produced and consumed!

Roughly speaking, the appropriate amount, taking into account the benefits that accrue from mitigating the problems being caused by the dollar, is being produced and consumed. It's just that some of the benefit is going to protecting retirement, college, and other investment accounts against the ravages of the falling dollar, and into stocking third world larders as a hedge against inflation and resulting future inability to purchase enough food with dollars or dollar-linked currencies, and some commodities consumption is

being deferred from this year to future years, rather than the entire benefit going to today's consumers, as occurs when the dollar is healthy.

So can you please explain to me how using commodities futures as an inflation hedge (or new currency) does not cause a negative impact (market distortion) on the actual market for the commodity?

It does cause negative impact and distortion in traditional Econ 101 terms (i.e. just looking at supply and demand for the commodity but not also for the dollar), though most of it is temporary: in the long run there will be sufficient stockpiles and institutional adjustments to support the use of commodities as a currency, probably without a substantial monetary premium on any given commodity, since there are so many commodities and much room for "fractional reserve" (i.e. having many more futures or other derivatives outstanding than commodities that actually are expected to be delivered at expiry -- we are currently going through a transition to this state, figuring out how to seamlessly "roll over" most futures).

If the commodities currencies still strike you as worse than the dollar, either because of the temporary problems we are experiencing now or because even in the long run there will be some (I suspect small) price premium due to the monetary value of commodities as currencies, the way to fix the problem is not to attack the symptoms (commodities currencies), but to attack root cause that gives rise to the need for commodity currencies (the poor management of the dollar). Attacking commodities "speculation" is like attacking the immune system, because the immune system proximately causes a fever, instead of attacking the disease that ultimately causes the fever. Attacking the immune system when you have a disease can kill you.

11:59 AM

Raj Natarajan said...

Thanks for explaining the theory clearly. I have been searching quite a while to understand the current phenomenon.

I do have a couple of concerns:

a) How can we assume that the markets will have the maturity and wherewithall to strike a balance and compensate as required for the weakning dollar. Especially with phenomenon like Zimbabwe at one end of the spectrum and BRIC nations on the other end?

b) How can we conclude that benevolent groups (retirees etc..) are using the commodity index approach? It could be soverign funds and may be oil producing countries fed up with weak dollar?

On the whole, what you say makes good sense. Thanks!

5:31 PM

Raj Natarajan said...

An after thought, why not go back to the gold standard?

5:32 PM

nick said...

raj: *How can we assume that the markets will have the maturity and wherewithall to strike a balance and compensate as required for the weakning dollar.*

Neither markets nor anything else can fully compensate for the weakening dollar. We can reduce but not avoid the extensive inefficiencies caused by changing inflation expectations and the resulting distortion of price signals away from those that would be given by an efficient market. Today's markets include very distorted prices (such as bizarre relative prices between oil and other energy sources) that wouldn't exist without the inflation expectations having driven up oil but not (as much, yet) most other energy

sources. On the other hand, if we have to just live with the inflation expectations, the markets are doing far better than any plan could to compensate for them. For example, inflation expectations in the floating currencies are making oil, like gold traditionally, become more important as a money substitute or hedge than as an energy source. So if we can't fix the floating currencies, we should be moving to other energy sources that are not nonrenewable commodities that behave like gold, and leave oil like gold to function primarily as a money substitute and hedge. That is just what the incentives created by high gas prices are doing.

How can we conclude that benevolent groups (retirees etc..) are using the commodity index approach? It could be soverign funds and may be oil producing countries fed up with weak dollar?

Everybody in the know with long-term savings who can hedge with commodity indices is doing so, whether one personally likes these savers or not. One's personal opinion of them does not justify violating their property rights. Furthermore, much (and probably most) of the oil price increase is driven simply by the "speculation" of oil countries pumping less until the price rises to match their heightened inflation expectations. No commodity market regulation can change that behavior. Even if commodity markets had been shut down the last 5 years, oil countries would have eventually caused the same price rises as the retirement and sovereign funds have caused by their decisions to slow down pumping oil until the price had risen to reflect the higher inflation expectations.

An after thought, why not go back to the gold standard?

It's not a bad idea: the 1970s and today demonstrate that the grand experiment with floating currencies produces too many price distortions to work well in a modern economy, and there are too many political influences to make every decade be like the placid 1980s and 1990s when floating currencies worked pretty well. In effect, a fractional reserve commodity index currency is just what is emerging in the international markets (by e.g. using the rollover positions technique to construct commodity index ETFs) but legal barriers which I've described elsewhere prevent us from using it instead of dollars for everyday transactions. Today in the U.S. when I write a check it must be denominated in an official government currency. Once I can write a check for "10 and 21/100 DBCs" instead of "473 and 94/100 dollars" we will have a more stable economy sending far more accurate price signals.

3:05 PM

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